CURRENTS

WESTERN CANADA'S ECONOMIC BULLETIN

CanadaWest FOUNDATION

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RESOURCE ROYALTIES → ASIA-PACIFIC TRADE → MANITOBA'S LIGHT OIL BOOM

Monthly Highlights

December employment declined in most of the West.

British Columbia saw a loss of 22,000 jobs (-1.0%), the largest single-month drop since January 2009, primarily in construction and health care. Alberta (2,400; -0.1%) and Manitoba (2,100; -0.3%) also experienced smaller declines. National employment increased by 22,000, due to increases in Ontario and Quebec.

With the exception of BC, which experienced a 0.7% increase, unemployment rates in December remained steady throughout Canada and the West. Manitoba continues to lead the country with 5.2% unemployment, well below the 7.6% national rate.

Consumer prices rose in every province in November compared to twelve months earlier. Alberta experienced a small increase at 0.1%, as declining energy prices offset price increases elsewhere. Manitoba also felt a smaller-than-average price growth of 1.1%. BC (2.2%) and Saskatchewan (2.0%) price increases were in line with the national average rate of 2%.

Retail sales grew in every Canadian province in October except for Manitoba, where sales fell for the second consecutive month. Sales in British Columbia increased for the third month in a row. Wholesale trade was down in the three of four western provinces, including Alberta, which saw its first decline in nearly a year. Manitoba was the exception, experiencing a fifth straight month of growth. Manufacturing sales were strong across the region. Although monthly sales declined in Manitoba and British Columbia in October, they are up on a year-over-year basis.

Monthly Economic Statistics	BC	AB	SK	MB	Canada	Reference Month
Labour Markets						
Employment (000s)	2,304	2,016	527	620	17,250	December
% change	-1.0	-0.1	0.0	-0.3	0.1	
Unemployment rate (%)	7.6	5.6	5.5	5.2	7.6	December
change in percentage points	0.7	0.0	0.0	0.1	0.0	
Participation rate (%)	65.4	72.3	70.0	69.4	66.9	December
Average weekly earnings ($)	833.96	1012.54	875.47	795.68	863.33	October
% change	1.6	1.6	3.4	0.8	0.0	
Inflation						
Consumer Price Index (% change)*	2.2	0.1	2.0	1.1	2.0	November
Economic Activity						
Retail trade ($M)	4,866	5,029	1,267	1,312	36,644	October
% change	1.2	0.7	0.1	-0.5	0.8	
Wholesale trade ($M)	4,027	5,333	1,354	1,194	44,870	October
% change	1.0	-2.4	-4.1	1.1	0.0	
Manufacturing sales ($M)	3,043	5,243	944	1,178	45,521	October
% change	-3.4	1.9	0.9	6.5	1.7	

** Compared to same month in previous year. Unless otherwise noted, data are seasonally adjusted and percent change is from previous period. Source: Statistics Canada.*

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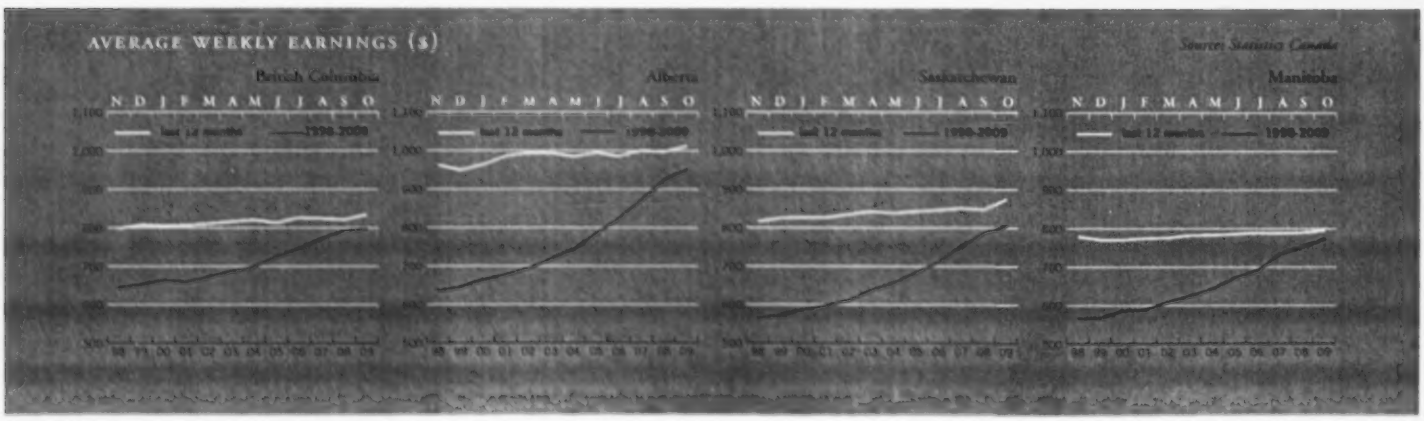
AVERAGE WEEKLY EARNINGS ($)

Source: Statistics Canada



Monthly Feature

Trade Diversification and Asia-Pacific Markets

Any financial advisor will tell you that investing your entire life's savings in the stock of a single company is a bad idea. No matter how secure, innovative or profitable that company may be, tying your future to a single organization is fraught with risk. We need to look no further than the impact of the oil spill in the Gulf of Mexico on stock in British Petroleum, or the impact of the global financial and economic crisis on US automakers and banks to remind ourselves of that lesson.

Instead, would-be investors are advised to diversify their investment portfolios. By spreading their wealth across a variety of assets, investors can protect themselves against the impact of a negative shock in any one investment, reducing their overall risk without a significant cost in terms of expected return.

This same argument about risk mitigation is sometimes used in international trade circles. Overreliance on exports to a limited number of markets, or on a narrow range of products, exposes an economy to the risks associated with external demand shocks. A recession, natural disaster or international conflict (to name just a few possibilities) in your largest export market can have a profound effect on the domestic economy. Diversification, whether through broadening your product base or customer base, can help insulate against such external shocks.

In western Canada, trade diversification is almost always discussed in relation to the United States. It is not hard to see why: the US is our dominant export partner, accounting for $92.2 billion out of the West's $128.9 billion in total merchandise exports worldwide in 2009. If demand in the US were to dry up, it could have serious repercussions in western Canada.

As it turns out, rapid expansion in trade with China and other developing Asia-Pacific markets may provide a solution to those concerns. While industrialized Asia-Pacific economies like Japan have long been important trading partners for western Canadians, there has been a tremendous increase in exports to the region's developing markets in recent years. Since 2001, western Canadian exports to developing markets in Asia-Pacific have risen by an average of 13.3% per year, compared to 1.6% per year for sales to the region's industrialized markets, and just 0.5% per year for exports to the US.

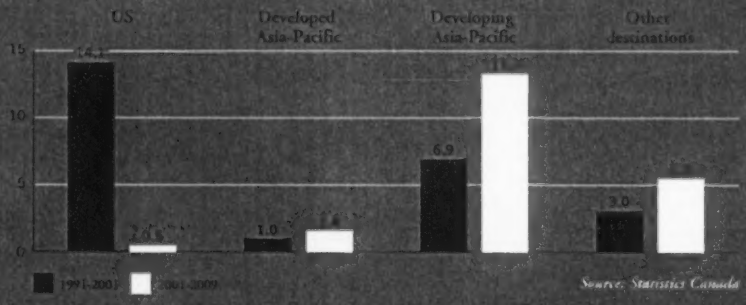
Many factors have contributed to these divergent performances including robust economic growth in China, a rising Canada-US exchange rate through the 2000s and the impact of lower energy prices on exports to the US in 2009. The end result, though, is that surging trade with developing markets in Asia-Pacific has helped western Canada to reduce its reliance on the US as an export market. From 2001 to 2009, the share of the region's total exports going to the US fell from 79.2% to 71.5%, while the share to developing markets in Asia-Pacific rose from 3.8% to 8.9%.

Whether this trend continues into the future remains to be seen. What is clear, however, is that Asia-Pacific holds enormous potential for the western provinces to expand both the volume of trade, and the range of goods and services they sell abroad. The challenge, from a public policy standpoint, is to ensure that western Canadian businesses are in the best possible position to succeed in those markets.

14.1%

average annual growth in western exports to the US between 1991-2001. In the last decade, growth has declined to 0.5%.

AVERAGE ANNUAL GROWTH IN WESTERN CANADIAN EXPORTS BY DESTINATION (%)



Source: Statistics Canada

DID YOU KNOW?

China and Japan are the most important export destinations in Asia-Pacific for all western provinces except Saskatchewan, where China and India top the list.

In 2009, the West's exports to Asia-Pacific markets totalled $22.6 billion, accounting for 17.5% of total exports worldwide.

At $9.5 billion in 2009, BC exported more to Asia-Pacific than any other province.

The western provinces account for two-thirds of Canada's total exports to Asia-Pacific.

Nearly half of western Canada's exports to Asia-Pacific in 2009 ($10.8 billion out of $22.6 billion) were to the region's developed markets. However, exports to these markets have grown by just 25% since 1990, while exports to China, India and other developing economies have risen by 428%.

BEHIND THE NUMBERS

The United States remains the West's biggest customer by a wide margin

Despite all of the hype around the economic rise of the BRIC countries—Brazil, Russia, India and China—the Unites States remains as western Canada's most significant trading partner. In 2009, the western provinces exported a total of $92.3 billion worth of goods to the US. Alberta was the most active trading partner with the US, shipping 83.4% of its goods there in 2009, compared to only 6.1% to China and Japan combined.

This dependency on the American market has long been considered an issue in western Canada and, while trade with other countries is increasing, the numbers indicate that western provinces have not yet diversified their international export base. The possible exception here is British Columbia, who exported only 50.1% of their goods to the US and 23.7% to Japan and China in 2009.

China

is the second largest trading partner for Alberta, Saskatchewan and Manitoba.

TOP TEN INTERNATIONAL MERCHANDISE TRADE DESTINATIONS 2009 (% OF TOTAL MERCHANDISE)

BC	2009	AB	2009
US	50.1	US	83.4
Japan	13.6	China	3.8
China	10.1	Japan	2.5
Korea, South	6.8	Mexico	1.5
Taiwan (Taipei)	1.8	Korea, South	0.8
Netherlands	1.7	Netherlands	0.4
Italy	1.3	Australia	0.4
UK	1.1	Russia	0.4
Brazil	1.0	Singapore	0.3
Germany	1.0	Saudi Arabia	0.3

SK	2009	MB	2009
US	60.7	US	66.8
China	5.2	China	6.1
India	4.5	Japan	4.8
UK	2.9	Mexico	2.5
Japan	2.9	Hong Kong	1.7
Indonesia	1.9	Australia	1.2
Mexico	1.7	Saudi Arabia	1.0
Bangladesh	1.6	UK	0.9
Italy	1.4	Iraq	0.9
Morocco	1.0	Russia	0.7

Source: Industry Canada, Trade Data Online

Energy Focus: Manitoba

Light Oil Boom

A light oil boom is driving Manitoba's record breaking activity with 520 wells drilled largely in the Waskada region. Until 2010, 2006 was the best year to date with 481 wells drilled. If history repeated itself, Manitoba was not due for another record break until 2057! With technology advancements in horizontal drilling and hydraulic fracing, Manitoba's oil industry is prospering.

Waskada, located in southwestern Manitoba, had not witnessed a boom since 1980 with discovery of the Spearfish formation. Producers extracted everything by the early 1990s because in geologic terms, the formation was considered "tight" and therefore very impermeable. However, with horizontal drilling—which now accounts for 85% of all Manitoba wells—oil majors including Tundra Oil and Gas, EOG Resources and Penn West have taken big stakes in the region. With existing infrastructure in place, those Canadian wells only cost about $1 million, making it an easy target for the typically higher price tag of unconventional drilling.

Tundra Oil and Gas light oil coiled tubing frac job site in Manitoba

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OPINION

BY MICHAEL HOLDEN, SENIOR ECONOMIST

Feast or Famine: Fiscal Planning and Resource Royalties

Resource royalties are a valuable source of revenue for provincial governments in western Canada. In fact, they have been rising steadily in importance since the early 1990s and are nearly as important to provincial government revenues today as they were at the tail end of the 1979 energy crisis. While royalties are a boon to governments' bottom lines, they present considerable challenges when it comes to long-term planning and fiscal management.

In 1981, resource royalties accounted for 23.8% of all provincial government revenues in western Canada, with a considerable range: in Alberta, royalties were as high as 43.2% of revenues, while the corresponding figures for Saskatchewan (21.0%), BC (5.6%) and Manitoba (1.4%) were much lower.

After tumbling in the 1980s and early 1990s, a surge in oil and other commodity prices in the mid to late 2000s have meant that royalties are once again a major source of income in the region, particularly in the three western most provinces. For western Canada as a whole, royalties made up 20.6% of government revenues in 2008 (the most recent year for which Statistics Canada data are available). Alberta still leads the pack at 33% of provincial revenues, but Saskatchewan and BC have seen the importance of resource royalties grow considerably since the early 1980s. In Saskatchewan, royalties grew to 24.1% of provincial revenues in 2008, while BC saw the share of income from royalties double to 11.2%.

Is this increasing reliance on royalty revenues a good thing for the western provinces? It really depends on your perspective. On one hand, royalties provide governments with more available funds to spend on goods and services—like health care, education, and infrastructure—or to put towards deficit elimination or debt reduction. This, in turn, eases the burden on provincial taxpayers; the more government revenues that come from resource rents, the less taxpayers have to pay out of their own pockets. By reducing the fiscal burden on taxpayers, royalties also contribute to creating a more competitive tax environment which could help attract businesses, investments and skilled workers to western Canada.

However, overreliance on resource royalties comes with its own set of problems. For one, royalties and royalty rates are closely linked to commodity prices which are notoriously volatile and completely beyond our control. While all government revenue sources are prone to fluctuations, royalty income is far more erratic than most. Responsible fiscal planning is an extraordinary challenge when a major source of revenue can fluctuate so dramatically, and unexpectedly, from one year to the next. How do governments make stable, predicable and long-term spending commitments in such an environment? How do they resist the pressure to increase spending when royalty income rises? And how do they maintain that spending level in the face of a negative price shock?

Additionally, the resources in question are non-renewable. To be sure, some of our resource deposits—like the oil sands—are vast, and some like shale gas are only beginning to be developed, but even these won't last forever. Moreover, environmental concerns and development of alternative energy sources could change future market conditions in unforeseeable ways.

Should we be concerned about the long-term sustainability of our royalty revenues? Should some of this resource wealth be saved for future generations? Are Albertans missing out on the opportunity to add to the Alberta Heritage Savings Trust Fund and convert part of their present wealth into a form that could provide interest revenue in perpetuity? Should Saskatchewan re-introduce its Heritage Fund? Should BC consider starting up such a fund?

These questions all require careful study, but two things are immediately clear. First, as resource royalties grow in importance for provincial governments in western Canada, steps need to be taken to minimize the impact of resource price volatility on government revenues. Secondly, better public policy is needed to ensure that both current and future generations benefit from present-day extraction of non-renewable resources.

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